94-SBE-002

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 87A-1093-TL
SIERRA PACIFIC INDUSTRIES	)	

Appearances:

For Appellant: Charles J. Moll, III
Attorney At Law

For Respondent: Karl F. Munz
Counsel

O P I N I O N

This appeal is made pursuant to section 26078[2/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Sierra Pacific Industries for refund of franchise tax in the amount of $185,928 for the income year ended December 31, 1971.

[2/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

The issues for determination are (1) whether the Franchise Tax Board's determinations are barred wholly or in part by the statute of limitations, and if not, whether the burden of proof has shifted to the Franchise Tax Board; (2) whether the Franchise Tax Board properly determined appellant's dividend income; (3) whether the Franchise Tax Board properly determined that appellant received additional taxable income of $2,289,080; and (4) whether the Franchise Tax Board properly determined that appellant's expenses relating to exempt income are nondeductible.

During the year in issue, appellant Sierra Pacific Industries, and its subsidiaries, conducted their business activities entirely in California. On January 1, 1971, appellant and a wholly owned subsidiary each owned 50 percent of the stock of Humboldt Flakeboard (Humboldt), a corporation engaged in the manufacture of particle board. Thus, appellant directly and indirectly owned 100 percent of Humboldt. In September 1971, Humboldt transferred its flakeboard plant, equipment and land to appellant, and characterized the transaction as a partial liquidation. Therefore, appellant reported a taxable gain of $6,856 (the fair market value of the assets ($4,030,000) less its basis in Humboldt stock ($4,023,144)). Thereafter, appellant and a third party (GATX) entered into a sale-leaseback agreement for the plant; however, appellant did not recognize any gain on the transaction, allegedly because its basis in the property ($4,023,144 basis in Humboldt stock plus recognized gain of $6,856) was equal to the sales price of $4,030,000. At the hearing, appellant's treasurer, Richard Smith, testified that the entire transaction was entered into so appellant could obtain financing from GATX. In January 1976, the Internal Revenue Service (IRS) issued an examination report, inclusive of the year at issue, which concluded that the transaction was not a partial liquidation but a dividend distribution from Humboldt to appellant in the amount of $4,030,000, the fair market value (FMV) of the property transferred.[3/] In early 1984, as part of the settlement of other issues with the IRS, appellant conceded that the $4,030,000 was a taxable dividend. On July 19, 1976, apparently in concurrence with the IRS' determination, respondent issued a notice of proposed assessment (NPA) for $282,425 to appellant.

In a June 8, 1987, notice of action, respondent accepted the IRS' characterization of the transaction as a dividend, but disagreed with the computation of the amount of the dividend and concluded that appellant recognized a gain from the sale-leaseback of the Humboldt property. Respondent determined that the $4,030,000 consisted of a dividend of $1,741,000 and taxable gain of $2,289,000. Respondent also determined that the dividend was nontaxable by virtue of section 24402, and expenses of $362,472 were disallowed since they related to the nontaxable dividend income. The proposed assessment was reduced to $185,928 and was offset against outstanding refunds due appellant. Appellant subsequently filed a refund claim, which was denied, and this appeal followed.

We first consider whether respondent's determinations are barred wholly or in part by the statute of limitations. Generally, every notice of additional tax proposed to be assessed (NPA) must be mailed to the taxpayer within four years after the return is filed. (Rev. & Tax. Code, § 25663.) If a

[3/] In another report (Form 886-A) the IRS indicated that this was an alternative issue. According to this report, the primary issue was disposed of in a related report covering Humboldt, which concluded that this transaction consisted of a sale-leaseback between Humboldt, <u>not appellant</u>, and GATX.

taxpayer reports any changes or corrections by the IRS, a proposed assessment resulting therefrom is required to be mailed within six months or the periods provided in sections 25663 or 25663c (relating to omission of more than 25 percent of gross income), whichever expires later. (Rev. & Tax. Code, § 25674.) If the taxpayer does not report any such change or correction, then the resulting proposed assessment must be mailed to the taxpayer within four years of the change or correction. (Rev. & Tax. Code, § 25673.) Appellant claims that respondent's June 8, 1987, notice of action was untimely as it raises new issues not covered by the NPA issued on July 19, 1976. We disagree.

It is undisputed that respondent's NPA was timely issued. Therein, respondent asserted a proposed deficiency resulting from the $4,030,000 dividend adjustment made by the IRS. After the appellant settled its case with the IRS in 1984, respondent issued its notice of action, recharacterizing the Humboldt transaction as a dividend distribution to appellant followed by a sale to GATX, ostensibly relying on additional information contained in the settlement agreement. When NPAs are issued within the statutory period, the fact that notices of action are not issued within the four-year period is irrelevant,[4/] and the Franchise Tax Board (FTB) may modify an NPA in order to reflect issues and conclusions developed during the protest. (See Appeal of Jenkel-Davidson Optical Co., Cal. St. Bd. of Equal., May 19, 1981.)

We find no error in respondent's action. One of the purposes of the NPA is to inform taxpayers so that they can intelligently lodge a protest. (See Appeal of Paul A. Laymon, Inc., Cal. St. Bd. of Equal., Oct. 6, 1976.) When the NPA was issued, appellant was on notice that respondent was reviewing the Humboldt transaction vis-a-vis the IRS audit. Appellant's own treasurer admitted the failed partial liquidation was part of a single plan to obtain financing for appellant, which culminated in the sale-leaseback with GATX. As such, we do not find persuasive appellant's claim of being prejudiced and not being on notice with respect to the items contained in the notice of action. Moreover, we have held that the respondent may withdraw its own notice of action within the 30-day period for appeal prescribed under section 25666, and that res judicata would not apply as there is no "final determination." (See Appeals of Rietz Manufacturing Co., Cal. St. Bd. of Equal., Feb. 28, 1984.) Given that ruling, it would be incongruous for us to accept appellant's statute of limitations claim and thereby impede the respondent's efforts to clarify the NPA via the notice of action so it more accurately reflects the facts of the Humboldt transaction as they were developed during the course of the federal audit. As we find the respondent's action to be timely, we next turn to the collateral issue of burden of proof.

If respondent's position on appeal results in a larger deficiency (had respondent adopted it initially), or requires the presentation of different evidence, then a new matter has been introduced and the burden of proving that new position shifts to respondent. However, if the assertion of a new theory merely clarifies or develops the original determination without being inconsistent with it or increasing the amount of the deficiency, it is not a new matter requiring the shifting of the burden of proof to respondent. (Appeal of David G. and Helen Mendelsohn, Cal. St. Bd. of Equal., Nov. 6, 1985; see also Zarin v. Commissioner, 92 T.C. 1084 (1989) and Achiro v. Commissioner, 77 T.C. 881 (1981) (interpreting Tax Court Rule 142(a)).) As indicated above, respondent's notice of action did not

[4/] See Appeal of King and Dorothy Crosno, et al., Cal. St. Bd. of Equal., Jan. 9, 1979.

increase the amount of the deficiency asserted in the NPA. In fact, the amount was decreased. In addition, it is logical for the respondent to modify its original determination so as to account for any new facts or information developed during the federal audit. The Humboldt transaction was the subject of respondent's NPA, and continues to be so on this appeal. Hence, we find that no new matter has been introduced which would shift the burden of proof to respondent. With the disposition of these procedural matters, we now focus our attention on the substance of the Humboldt transaction.

The Humboldt transaction was reported as a partial liquidation for income tax purposes. (See Rev. & Tax. Code, § 24516 and I.R.C. § 346 for the definition of a partial liquidation.) Indeed, such a characterization allowed Humboldt to avoid any gain otherwise recognizable on the distribution. (See Rev. & Tax. Code, § 24481 and I.R.C. § 311(d) (relating to gain on distributions of appreciated property), and Rev. & Tax. Code, § 24511 and I.R.C. § 336 (relating to the nonrecognition of gain or loss on liquidations).) Appellant, in turn, was only required to recognize a relatively minuscule gain on the exchange of its Humboldt shares for the Humboldt property,[5/] compared to a huge step-up in basis for such distributed property. (See Rev. & Tax. Code, § 24501(b) and I.R.C. § 331(a)(2) (concerning the calculation of gain to shareholders in corporate liquidations), and Rev. & Tax. Code, § 24504(a) and I.R.C. § 334(a) (concerning the computation of the basis of property received in liquidations).) Thus, appellant received property with a $2,274,482 increase in basis ($4,030,000 (FMV of property received) less $1,755,518 (adjusted basis in the hands of Humboldt[6/])), while recognizing a gain of $6,856 ($4,030,000 (FMV of property received) less $4,023,144 (adjusted basis of Humboldt stock)). (See, generally, <u>Appeals of Crafton Water Co., et al.</u>, Cal. St. Bd. of Equal., Oct. 26, 1983, for treatment of partial liquidations.) Thus, to the extent the sale-leaseback with GATX was deemed to be a taxable sale, no gain would be recognized ($4,030,000 (cash received from GATX) less $4,030,000 (basis of property in hands of appellant after distribution from Humboldt)). However, when the IRS audited appellant and recast the transaction as essentially equivalent to a dividend, this heretofore palatial plan turned into nothing more than a house of cards. Appellant's subsequent concession in 1984 foreclosed the availability of the partial liquidation rules.[7/] In their stead lurked the specter of the general corporate distribution rules.[8/]

Such rules provide that, for corporate shareholders, the amount of any distribution shall be equal to the money received plus the lesser of (a) the fair market value of the property distributed or

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[5/] Appellant would also be able to avoid the effects of a dividend distribution. (See Rev. & Tax. Code, § 24501(b); I.R.C. § 331(b).)

[6/] The record indicates that the basis of the distributed property in the hands of Humboldt was either $1,740,000, $1,740,290, or $1,755,518. In making our determination of the amount of the distribution, we shall use $1,755,518, which was the basis reported by Humboldt on its return.

[7/] (See <u>i.e.</u>, Rev. & Tax. Code, § 24516 (I.R.C. § 346), Rev. & Tax. Code, § 24511 (I.R.C. § 336), Rev. & Tax. Code, § 24504 (I.R.C. § 334), and Rev. & Tax. Code, § 24501 (I.R.C. § 331).)

[8/] (See <u>i.e.</u>, Rev. & Tax. Code, §§ 24452, 24453, 24454 (I.R.C. § 301), Rev. & Tax. Code, §§ 24481 through 24483.5 (I.R.C. § 311), Rev. & Tax. Code, § 24901 (I.R.C. § 1001), and Rev. & Tax. Code, § 24902 (I.R.C. § 1002).)

(b) the adjusted basis of the distributed property immediately before the distribution, increased by any gain recognized by the distributing corporation. (Rev. & Tax. Code, § 24452; I.R.C. § 301(b)(1)(B).) Likewise, the basis of the distributed property in the hands of the corporate shareholder is equal to the lesser of (a) the fair market value of the property distributed or (b) the adjusted basis of the distributed property immediately before the distribution, increased by any gain recognized by the distributing corporation. (Rev. & Tax. Code, § 24454; I.R.C. § 301(d).) While a distribution which is deemed to be a dividend is includible in gross income and taxable,[9/] appellant is eligible for a 100-percent deduction for California franchise tax purposes and an 85-percent deduction for federal income tax purposes. (See Rev. & Tax. Code, § 24402; I.R.C. § 243(a)(1).) For federal income tax purposes, the IRS determined that appellant received a dividend in the amount of $4,030,000. In a valiant attempt to salvage this transaction, appellant argues that the amount of the dividend should also be $4,030,000 for California franchise tax purposes. We disagree.

It is well settled that a determination with respect to federal income tax liability will generally be followed when determining California tax liability where the applicable federal and state provisions are identical and where there is no compelling reason for departure from the federal interpretation. (See Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L.Ed. 510] (1941).) However, the respondent is not required to follow an "erroneous" IRS computation. (Appeal of Krofft Entertainment, Inc., Cal. St. Bd. of Equal., Apr. 5, 1984.) This board does not dispute the IRS' recasting of the Humboldt transaction as a dividend. Thus, while we believe the amount of the dividend should be less than $4,030,000, we do not concur with respondent's allegation that the IRS made an error in its calculations. The relevant statutory provisions indicate that the starting point for computing the amount of the dividend is the fair market value of the Humboldt property, which has been established as $4,030,00. This figure is compared with the adjusted basis of the distributed property in the hands of Humboldt immediately before the transaction. We have determined that amount to be $1,755,518. Clearly, the adjusted basis of the Humboldt property is less than its fair market value. As underscored above, if Humboldt had recognized any gain on this transaction, the amount of any such gain would be added to the property's adjusted basis and then compared with its fair market value to determine the amount of the dividend. We know that, since appellant characterized this transaction as a partial liquidation, no gain was recognized by Humboldt ab initio. While the record is sparse on this point, the IRS report does indicate that Humboldt was also under audit for the same transaction. Thus, if the IRS had imputed a recognized gain onto Humboldt, then the federal government's calculation of the dividend amount might very well be accurate. However, for California franchise tax purposes, the record is barren as to whether Humboldt ever recognized a gain on this transaction. There is no allegation that Humboldt amended its California return to account for the gain on this distribution. The taxpayer has the burden of disproving the FTB's determinations, which are presumptively correct. (Todd v. McColgan, 89 Cal.App. 2d 509 [201 P.2d 414] (1949).) Thus, we must find that Humboldt has not recognized any gain on this transaction for California franchise tax purposes, that respondent's method of computing the dividend is correct, and that the amount of the dividend should be $1,755,518. Furthermore, since its computation is similar to the calculation of the dividend amount, we conclude that the basis of the distributed property in the hands of appellant was

[9/] Rev. & Tax. Code, § 24453, subd. (a); I.R.C. § 301(c).

$1,755,518. Hence, there has been no divergence from the IRS' interpretation of the corporate distribution rules. The respondent merely reached a different result based on a set of circumstances relevant only for California tax purposes.

Appellant attempts to make an end-run around these results by averring that even though the distribution is equivalent to a dividend, it can still be treated as a stock redemption eligible for sale or exchange treatment. (See Rev. & Tax. Code, § 24455, subd. (a); I.R.C. § 302(a).) While appellant has not submitted any legal support for this theory,[10/] other than providing us with the definition of a redemption,[11/] we find its resolution to be an academic matter not relevant to the issues before us. Even assuming arguendo the transaction can still be characterized as a redemption, appellant must also qualify under the special redemption rules in order to receive sale or exchange treatment. (See Rev. & Tax. Code, § 24455, subd. (b); I.R.C. § 302(b).) Again, as to this point, the record is barren. Moreover, the statutes provide that if the redemption does not qualify as a sale or exchange, then it must be treated under the general corporate distribution rules. (See Rev. & Tax. Code, § 24455, subd. (d); I.R.C. § 302(d).)[12/] With this in mind, we next turn to the transaction with GATX.[13/]

Here, appellant is placed in the unenviable position of claiming that the form of its own transaction is without substance and should be ignored. It is accepted that taxpayers are generally free to choose the manner by which to structure their affairs, even when motivated by tax reduction considerations. (See Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 196 (1983), affd. on this issue, 752 F.2d 89 (4th Cir. 1985).)[14/] Once having done so, however, they are bound by the tax consequences of that choice,

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[10/] Unsubstantiated assertions are not sufficient to satisfy the burden of proof. (Appeal of James Petroleum Corp., Cal. St. Bd. of Equal., May 4, 1978.)

[11/] See Rev. & Tax. Code, § 24496, subd. (b); I.R.C. § 317(b).

[12/] Appellant also argues that section 24483.5 (I.R.C. § 311(d)) is applicable, regardless of whether the distribution is characterized as a dividend or a redemption. We decline to decide this issue because, again, even if section 24483.5 applies, appellant must prove that Humboldt recognized gain on the distribution for California franchise tax purposes in order to receive a step-up in basis for the distributed property. As discussed above, appellant has not met its burden of proof on this point.

[13/] In a final, but futile, attempt to obtain a step-up in basis for the Humboldt property, appellant contends that respondent must account for the basis of the Humboldt stock surrendered in this transaction, and cites Treasury Regulation section 1.302-2(c). But, that regulation only indicates that an adjustment should be made to the basis of any remaining stock in the shareholder's hands, not to the property distributed. Nevertheless, appellant claims that since it no longer owned any more shares of Humboldt after the distribution, the basis of the surrendered Humboldt stock must attach to "something." Of course, appellant wants this "something" to be the Humboldt property. However, appellant has cited no legal authority for this position, and should not be heard to complain when it failed to properly report this transaction for franchise tax purposes (i.e., if appellant had been able to establish that Humboldt reported the gain on the distribution of this property for California tax purposes, then this particular issue would be moot).

[14/] Nevertheless, a transaction entered into solely for tax benefits, which has no economic, commercial, or legal purpose other than the expected tax benefits, is an economic sham and without effect for federal income tax purposes.

whether contemplated or not, and they may not enjoy the benefits of some other path they might have chosen to follow, but did not. (Don E. Williams Co. v. Commissioner, 429 U.S. 569 [51 L.Ed.2d 48] (1977); Commissioner v. National Alfalfa Dehydrating, 417 U.S. 134 [40 L.Ed.2d 717] (1974).)

Furthermore, it is well established that the economic substance of a transaction, rather than its form, governs whether a transaction is a bona fide sale or lease for income tax purposes. (See Frank Lyon Co. v. United States, 435 U.S. 561, 573 [55 L.Ed.2d 550] (1978).) The characterization of a transaction for federal income tax purposes is controlled by the substantive provisions of the agreement and the taxpayer's conduct, rather than by the terminology used in the agreements. (Swift Dodge v. Commissioner, 692 F.2d 651, 652 (9th Cir. 1982).)

Appellant argues that the sale-leaseback with GATX was, in reality, a loan. The essence of a sale is the transfer of property for a price. A loan, however,

> is the delivery of a sum of money to another under a contract to return at some future time an equivalent amount with or without an additional sum agreed upon for its use; and if such be the intent of the parties the transaction will be deemed a loan regardless of its form.

(Milana v. Credit Discount Co., 27 Cal.2d 335, 339 [163 P.2d 869] (1945).)

However, the only evidence presented in support of appellant's claim is the unsubstantiated testimony of its treasurer. No documentation was ever submitted, and there is no indication as to how GATX treated this transaction. We do not know what GATX' legal remedy would have been if appellant had missed a payment, or whether the "loan" was with or without recourse.

> When the so-called borrower is not required to repay the loan, and where a lender must look to the property which the lender has authorized the borrower to take, and when the borrower may cancel the obligation at his option, the transaction is much more consistent with a sale than with a loan. The word "loan" implies an advance of money with an absolute promise to repay.

(Bankers Mortgage Co. v. Commissioner, 142 F.2d 130, 131 (5th Cir. 1944).)

(..continued)
(Frank Lyon Co. v. United States, 435 U.S. 561 [55 L.Ed.2d 550] (1978); Rice's Toyota World, Inc. v. Commissioner, supra, 81 T.C. at 196; Appeal of Bender Machine, Inc., 92-SBE-004, Apr. 23, 1992.)

> The incidence of taxation depends upon the substance of a transaction. . . . [T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

(Commissioner v. Court Holding Co., 324 U.S. 331, 334 ;[89 L.Ed. 981] (1945).)

Appellant concedes that title to the Humboldt property was transferred to GATX, but avers that this was only for purposes of securing the loan. We agree that "taxation is not so much concerned with the refinements of title as it is with actual command over the property. (Corliss v. Bowers, 281 U.S. 376, 378 [74 L.Ed. 916] (1930); Griffiths v. Helvering, 308 U.S. 355, 357 [84 L.Ed. 319] (1939); Appeal of American A-One Investment Co., Cal. St. Bd. of Equal., Nov. 27, 1956.)

> Moreover, it has been widely recognized in numerous cases that a deed or bill of sale which appears on its face to convey title absolutely, may nevertheless be found from a consideration of all the facts and surrounding circumstances to constitute merely a device for providing security for money loaned, such as a mortgage.

(Comtel Corp. et al. v. Commissioner, 45 T.C. 294, 305 (1965), affd., 376 F.2d 791 (2d Cir. 1967).)

However, the appellant has not provided us with sufficient information on this point and has again failed to meet its burden of proof.

Our final determination concerns the propriety of respondent's disallowance of expenses related to the distribution. Deductions are a matter of legislative grace and are allowable only where the conditions established by the legislature have been satisfied. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Frederick A. Sebring, Cal. St. Bd. of Equal., Dec. 9, 1980.) Respondent's determination that a deduction should be disallowed is presumed correct (Welch v. Helvering, 290 U.S. 111 [78 L.Ed. 212] (1933); Appeal of John A. and Julie M. Richardson, Cal. St. Bd. of Equal., Oct. 28, 1980), and the taxpayer must prove his entitlement to the claimed deductions. (Appeal of Ambrose L. and Alice M. Gordos, Cal. St. Bd. of Equal., Mar. 31, 1982.)

Section 24425 provides, in part, that dividend income deductible under section 24402 is considered a class of income not includible in the measure of tax, and, thus, expenses allocable thereto are not deductible. Section 24425 is operative whenever income is eliminated from the measure of tax. (See Great Western Financial Corp. v. Franchise Tax Board, 4 Cal.3d 1, 6 [92 Cal.Rptr. 489] (1971).) In determining the amount of expenses disallowed, respondent utilized the following allocation formula:

$$\frac{\text{Deductible Dividend Income}}{\text{Total Income}} \quad X \quad \text{Total Expenses} = \text{Nondeductible Expenses}$$

Such a formula has already passed judicial scrutiny (see Great Western Financial Corp. v. Franchise Tax Board, supra, as noted by this board in the Appeal of Mission Equities Corp., decided on January 7, 1975. Appellant contends that almost none of the claimed expenses were related to the deemed dividend, but has submitted no evidence other than the unsubstantiated testimony of its treasurer to support its claim. After the hearing, respondent, on its own motion, reduced the amount of the disallowed expenses to $200,940. However, since appellant has not established that the balance of these expenses were unrelated to the excluded dividend income, we must sustain respondent's action. (See Great Western Financial Corp. v. Franchise Tax Bd., supra, 4 Cal.3d at 7.)

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Sierra Pacific Industries for refund of franchise tax in the amount of $185,928 for the income year ended December 31, 1971, be and the same is hereby modified in accordance with respondent's concession regarding the amount of nondeductible expenses. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 5th day of January, 1994, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong and Ms. Scott present.

Brad Sherman, Chairman

Matthew K. Fong, Member

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

______________________, Member

* For Gray Davis per Government Code section 7.9.

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